TIERONE CORP
Form 10-Q
November 07, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission file number: 000-50015

TierOne Corporation

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

Wisconsin	04-3638672
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
1235 N Street Lincoln, Nebraska	68508
(Address of Principal Executive Offices)	(Zip Code)

(402) 475-0521

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes _X_ No ___

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ___ Accelerated filer _X_ Non-accelerated filer ___

Indicated by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ___ No _X_

As of November 5, 2007, there were 18,059,260 issued and outstanding shares of the Registrant s common stock.

PART I - FINANCIAL INFORMATION

Item 1 Financial Statements

TierOne Corporation and Subsidiaries
Consolidated Statements of Financial Condition
September 30, 2007 (Unaudited) and December 31, 2006

(Dollars in thousands, except per share data)	September 30, 2007	December 31, 2006
ASSETS		
Cash and cash equivalents	$ 75,055	$ 86,808
Federal funds sold	107,500	--
Total cash and cash equivalents	182,555	86,808
Investment securities:		
Held to maturity, at cost which approximates fair value	75	90
Available for sale, at fair value	149,751	105,000
Mortgage-backed securities, available for sale, at fair value	7,687	12,272
Loans receivable:		
Net loans (includes loans held for sale of $20,462 and $19,285 at September 30, 2007 and December 31, 2006, respectively)	3,020,865	3,050,160

(Dollars in thousands, except per share data)		September 30, 2007		December 31, 2006
Allowance for loan losses		(58,793)		(33,129)
Net loans after allowance for loan losses		2,962,072		3,017,031
FHLBank Topeka stock, at cost		64,936		62,022
Premises and equipment, net		38,525		39,821
Accrued interest receivable		23,855		23,023
Goodwill		42,101		42,228
Other intangible assets, net		7,134		8,391
Mortgage servicing rights (lower of cost or market), net		13,696		12,467
Other assets		50,290		22,016
Total assets	$	3,542,677	$	3,431,169
LIABILITIES AND STOCKHOLDERS EQUITY				
Liabilities:				
Deposits	$	2,354,838	$	2,052,343
FHLBank Topeka advances and other borrowings		767,303		962,376
Advance payments from borrowers for taxes, insurance and other escrow funds		17,107		27,203
Accrued interest payable		6,132		6,620
Accrued expenses and other liabilities		34,220		29,344
Total liabilities		3,179,600		3,077,886
Stockholders equity:				
Preferred stock, $0.01 par value. 10,000,000 shares authorized; none issued		--		--
Common stock, $0.01 par value. 60,000,000 shares authorized; 18,054,202 and 18,041,413 shares issued at September 30, 2007 and December 31, 2006, respectively		226		226
Additional paid-in capital		364,438		358,733
Retained earnings, substantially restricted		114,364		112,111
Treasury stock, at cost; 4,520,873 and 4,533,662 shares at September 30, 2007 and December 31, 2006, respectively		(105,118)		(105,406)
Unallocated common stock held by Employee Stock Ownership Plan		(10,535)		(11,664)
Accumulated other comprehensive loss, net		(298)		(717)
Total stockholders equity		363,077		353,283
Total liabilities and stockholders equity	$	3,542,677	$	3,431,169

See accompanying notes to consolidated financial statements.

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TierOne Corporation and Subsidiaries
Consolidated Statements of Income
(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(Dollars in thousands, except per share data)	2007	2006	2007	2006

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
Interest income:				
Loans receivable	$ 55,969	$ 57,562	$ 168,505	$ 158,333
Investment securities	2,993	2,424	8,277	6,601
Other interest-earning assets	943	3	1,329	79
Total interest income	59,905	59,989	178,111	165,013
Interest expense:				
Deposits	21,828	15,614	59,087	43,023
FHLBank Topeka advances and other borrowings	8,761	10,234	27,829	27,309
Total interest expense	30,589	25,848	86,916	70,332
Net interest income	29,316	34,141	91,195	94,681
Provision for loan losses	17,483	1,148	29,184	4,290
Net interest income after provision for loan losses	11,833	32,993	62,011	90,391
Noninterest income:				
Fees and service charges	6,050	5,585	17,249	16,268
Debit card fees	871	702	2,492	2,003
Loss from real estate operations, net	(191)	(55)	(470)	(120)
Net gain (loss) on sales of:				
Investment securities	--	--	--	21
Loans held for sale	374	396	1,936	1,566
Real estate owned	147	(2)	(185)	(66)
Other operating income	273	303	830	858
Total noninterest income	7,524	6,929	21,852	20,530
Noninterest expense:				
Salaries and employee benefits	13,010	12,526	39,306	36,469
Occupancy, net	2,409	2,311	7,213	6,685
Data processing	610	547	1,807	1,648
Advertising	1,525	1,177	3,790	3,638
Other operating expense	10,108	4,550	19,858	13,008
Total noninterest expense	27,662	21,111	71,974	61,448
Income (loss) before income taxes	(8,305)	18,811	11,889	49,473
Income tax expense (benefit)	(2,425)	7,294	5,932	19,047
Net income (loss)	$ (5,880)	$ 11,517	$ 5,957	$ 30,426
Net income (loss) per common share, basic	$ (0.35)	$ 0.70	$ 0.36	$ 1.85
Net income (loss) per common share, diluted	$ (0.34)	$ 0.67	$ 0.35	$ 1.78
Dividends declared per common share	$ 0.08	$ 0.07	$ 0.23	$ 0.20
Average common shares outstanding, basic (000 s)	16,758	16,557	16,679	16,470

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
Average common shares outstanding, diluted (000 s)	17,211	17,228	17,178	17,130

See accompanying notes to consolidated financial statements.

TierOne Corporation and Subsidiaries
Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income
For the Nine Months Ended September 30, 2007 and 2006
(Unaudited)

(Dollars in thousands)	Common Stock	Additional Paid-In Capital	Retained Earnings, Substantially Restricted	Treasury Stock	Unallocated Common Stock Held by the Employee Stock Ownership Plan	Unearned Common Stock Held by the Management Recognition and Retention Plan	Accumulated Other Comprehensive Loss, Net	Total Stockholders Equity
Balance at December 31, 2005	$ 226	$ 358,587	$ 75,282	$ (101,584)	$ (13,169)	$ (9,368)	$ (1,107)	$ 308,867
Common stock earned by employees in Employee Stock Ownership Plan	--	2,576	--	--	1,129	--	--	3,705
Transfer of unearned common stock held by the Management Recognition and Retention Plan upon adoption of SFAS No. 123(R)	--	(9,368)	--	--	--	9,368	--	--
Amortization of awards under the Management Recognition and Retention Plan	--	2,178	--	--	--	--	--	2,178
Amortization of stock options under 2003 Stock Option Plan upon adoption of SFAS No. 123(R)	--	1,261	--	--	--	--	--	1,261
Repurchase of common stock (21,724 shares)	--	--	--	(728)	--	--	--	(728)
Treasury stock reissued under 2003 Stock Option Plan	--	(216)	--	1,003	--	--	--	787
Excess tax benefit realized from stock-based compensation plans	--	939	--	--	--	--	--	939
Tax benefit realized from certain costs deducted in mutual to stock conversion	--	780	--	--	--	--	--	780
Dividends paid ($0.20 per common share)	--	--	(3,322)	--	--	--	--	(3,322)
Comprehensive income:								
Net income	--	--	30,426	--	--	--	--	30,426
Change in unrealized loss on available for sale securities, net of tax and reclassification adjustment	--	--	--	--	--	--	256	256
Total comprehensive income	--	--	30,426	--	--	--	256	30,682
Balance at September 30, 2006	$ 226	$ 356,737	$ 102,386	$ (101,309)	$ (12,040)	$ --	$ (851)	$ 345,149
Balance at December 31, 2006	$ 226	$ 358,733	$ 112,111	$ (105,406)	$ (11,664)	$ --	$ (717)	$ 353,283
Common stock earned by employees in Employee Stock Ownership Plan	--	1,951	--	--	1,129	--	--	3,080
Amortization of awards under the								

(Dollars in thousands)	Common Stock	Additional Paid-In Capital	Retained Earnings, Substantially Restricted	Treasury Stock	Unallocated Common Stock Held by the Employee Stock Ownership Plan	Unearned Common Stock Held by the Management Recognition and Retention Plan	Accumulated Other Comprehensive Loss, Net	Total Stockholders Equity
Retention Plan	--	2,178	--	--	--	--	--	2,178
Amortization of stock options under Management Recognition and 2003 Stock Option Plan	--	1,261	--	--	--	--	--	1,261
Repurchase of common stock (7,111 shares)	--	--	--	(175)	--	--	--	(175)
Treasury stock reissued under 2003 Stock Option Plan	--	(108)	--	463	--	--	--	355
Excess tax benefit realized from stock-based compensation plans	--	423	--	--	--	--	--	423
Dividends paid ($0.23 per common share)	--	--	(3,861)	--	--	--	--	(3,861)
Cumulative effect of adoption of FASB Interpretation No. 48 on January 1, 2007	--	--	157	--	--	--	--	157
Comprehensive income:								
Net income	--	--	5,957	--	--	--	--	5,957
Change in unrealized loss on available for sale securities, net of tax and reclassification adjustment	--	--	--	--	--	--	419	419
Total comprehensive income	--	--	5,957	--	--	--	419	6,376
Balance at September 30, 2007	$ 226	$ 364,438	$ 114,364	$ (105,118)	$ (10,535)	$ --	$ (298)	$ 363,077

See accompanying notes to consolidated financial statements.

TierOne Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

(Dollars in thousands)	For the Nine Months Ended September 30, 2007	2006
Cash flows from operating activities:		
Net income	$ 5,957	$ 30,426
Adjustments to reconcile net income to net cash provided by operating activities:		
Net premium amortization (accretion) of investment and mortgage-backed securities	(1,073)	33
Premises and equipment depreciation and amortization	3,016	2,781
Amortization of other intangible assets	1,257	1,328
Amortization of discount on FHLBank Topeka advances	(191)	(191)
Employee Stock Ownership Plan compensation expense	3,080	3,705
2003 Management Recognition and Retention Plan compensation expense	2,178	2,178
2003 Stock Option Plan compensation expense	1,261	1,261
Accretion of discounts on net loans	(2,781)	(1,582)
FHLBank Topeka stock dividend	(2,914)	(2,560)
Deferred income tax expense (benefit)	(11,780)	417
Provision for loan losses	29,184	4,290

	For the Nine Months Ended September 30,	
Provision for real estate owned losses	177	322
Provision for uncollectible receivable	4,767	--
Proceeds from sales of loans held for sale	235,307	184,161
Originations and purchases of loans held for sale	(234,548)	(190,619)
Excess tax benefits from stock-based compensation plans	(423)	(939)
Net (gain) loss on sales of:		
Investment securities	--	(21)
Loans held for sale	(1,936)	(1,566)
Real estate owned	185	66
Premises and equipment	9	(110)
Changes in certain assets and liabilities:		
Accrued interest receivable	(832)	(3,914)
Other assets	(20,978)	(2,094)
Accrued interest payable	(488)	(908)
Accrued expenses and other liabilities	5,456	1,086
Net cash provided by operating activities	13,890	27,550
Cash flows from investing activities:		
Purchase of investment and mortgage-backed securities, available for sale	(230,338)	(59,685)
Proceeds from sale of investment and mortgage-backed securities, available for sale	10	2,297
Proceeds from maturities of investment securities, available for sale	187,281	45,780
Proceeds from principal repayments of investment and mortgage-backed securities, available for sale and held to maturity	4,651	5,536
Decrease (increase) in loans receivable	24,076	(140,162)
Additions to premises and equipment	(1,729)	(3,934)
Proceeds from sale of premises and equipment	--	367
Proceeds from sale of real estate owned	3,647	5,085
Marine Bank branch purchase - net of cash acquired	--	7,568
Net cash used in investing activities	(12,402)	(137,148)

See accompanying notes to consolidated financial statements.

TierOne Corporation and Subsidiaries
Consolidated Statements of Cash Flows (continued) (Unaudited)

	For the Nine Months Ended September 30,	
(Dollars in thousands)	**2007**	**2006**
Cash flows from financing activities:		
Net increase (decrease) in deposits	$ 302,495	$ (42,373)
Net advances (repayment) on FHLBank Topeka line of credit, short-term advances and other borrowings	(44,722)	43,637
Proceeds from FHLBank Topeka long-term advances and other borrowings	50,000	390,000
Repayments of FHLBank Topeka long-term advances and other borrowings	(200,160)	(300,153)
Net decrease in advances from borrowers for taxes, insurance and other escrow funds	(10,096)	(5,873)
Repurchase of common stock	(175)	(728)
Dividends paid on common stock	(3,861)	(3,322)
Excess tax benefit realized from the exercise of stock options	45	130
Excess tax benefit realized from Management Recognition and Retention Plan shares	378	809

	For the Nine Months Ended September 30,	
Proceeds from the exercise of stock options	355	787
Net cash provided by financing activities	94,259	82,914
Net increase (decrease) in cash and cash equivalents	95,747	(26,684)
Cash and cash equivalents at beginning of period	86,808	88,034
Cash and cash equivalents at end of period	$ 182,555	$ 61,350
Supplemental disclosures of cash flow information:		
Cash paid during period for:		
Interest	$ 87,404	$ 72,148
Income taxes, net of refunds	$ 17,265	$ 18,354
Noncash investing activities:		
Transfers from loans to real estate owned and other assets through foreclosure	$ 5,657	$ 8,011

See accompanying notes to consolidated financial statements.

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TierOne Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note 1 Basis of Presentation and Consolidation

TierOne Corporation (Company) is a Wisconsin corporation headquartered in Lincoln, Nebraska. TierOne Corporation is the holding company for TierOne Bank (Bank). The Bank has two wholly owned subsidiaries, TMS Corporation of the Americas (TMS) and United Farm & Ranch Management, Inc. (UFARM). TMS is the holding company of TierOne Investments and Insurance, Inc. (d/b/a TierOne Financial), a wholly owned subsidiary that administers the sale of securities and insurance products, and TierOne Reinsurance Company, a wholly owned subsidiary that reinsures credit life and disability insurance policies. UFARM provides agricultural customers with professional farm and ranch management and real estate brokerage services. The accompanying unaudited consolidated financial statements include the accounts of the Bank and its wholly owned subsidiaries.

The assets of the Company, on an unconsolidated basis, primarily consist of 100% of the Bank s common stock. The Company has no significant independent source of income and therefore depends on cash distributions from the Bank to meet its funding requirements.

The accompanying interim consolidated financial statements as of September 30, 2007 and for the three and nine months ended September 30, 2007 and 2006 are unaudited. All significant intercompany accounts and transactions have been eliminated in consolidation. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and operating results for interim periods. The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information, in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC), and do not include all of the information and notes required for complete, audited financial statements. The unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006. The results of operations for the three and nine months ended September 30, 2007 are not necessarily indicative of the results which may be expected for the entire calendar year 2007.

Subsequent to the filing of our June 30, 2007 Quarterly Report on Form 10-Q, we assumed servicing of all loans purchased from TransLand Financial Services, Inc. (TransLand), a Florida mortgage brokerage firm. This step has allowed us to directly contact each borrower and restructure terms for their loan where appropriate. To assist in the settlement and completion of these loans, we have implemented a plan dedicating a team of Bank loan officers, servicers and collection professionals whose responsibility is to be primarily focused on these loans. This team is working closely with individual borrowers, local builders, city officials, local real estate professionals and legal counsel in working toward completing homes under construction, renegotiating loan terms, servicing loans and pursuing legal and foreclosure remedies.

During our due diligence process related to the transfer of residential construction loan servicing from TransLand to the Bank, alleged fraudulent servicing practices were discovered. The majority of the alleged fraud related to the withholding of loan payoff proceeds and periodic payments. A joint petition for involuntary Chapter 11 bankruptcy was filed on August 23, 2007 in the United States Bankruptcy Court for the Middle District of Florida by the Bank and two other financial institutions against TransLand. In addition to seeking recoveries from TransLand, the Bank is also insured up to $7.5 million against fraudulent activity by loan servicers. A $6.9 million receivable from TransLand associated with the alleged misappropriation of loan payoff proceeds and periodic payments due to the Bank was recorded as loans receivable at June 30, 2007. During the quarter ended September 30, 2007, the $6.9 million receivable increased to $12.2 million. The Company determined the recovery from its insurance carrier was probable and wrote-off $4.8 million of the receivable as a charge to other operating expense during the third quarter. A receivable of $7.4 million is now recorded as other assets on the Company s Consolidated Statements of Financial Condition at September 30, 2007. Any future recoveries from TransLand beyond the insurance policy amount would be recorded as other operating income or a reduction of other operating expense depending upon the periods in which the funds are received. Management determined that the effect of the modification was not material in relation to the consolidated financial statements included in our June 30, 2007 Quarterly Report of Form 10-Q.

As used in this report, unless the context otherwise requires, the terms we, us, or our refer to the Company and the Bank.

Note 2 Definitive Acquisition Agreement

On May 17, 2007, TierOne Corporation, CapitalSource Inc. (CapitalSource) and CapitalSource TRS Inc. (CapitalSource TRS) entered into and announced an Agreement and Plan of Merger (Merger Agreement). The Merger Agreement provides that, upon the terms and subject to conditions set forth in the Merger Agreement, the Company will merge with and into CapitalSource TRS (Merger), with CapitalSource TRS continuing as the surviving corporation.

Subject to the terms and conditions of the Merger Agreement, at the effective time and as a result of the Merger, each issued and outstanding share of Company common stock (other than certain shares owned by the Company), par value $0.01 per share (TierOne Common Stock), will be converted into the right to receive the following (collectively, the Merger Consideration):

$6.80 in cash; plus
0.675 shares of CapitalSource common stock; plus
if the ten-day average closing price of CapitalSource common stock prior to the closing of the Merger is:
(a) less than or equal to $25.1852, then 0.405 shares of CapitalSource common stock; or
(b) greater than $25.1852, then TierOne Corporation stockholders can elect to receive either $10.20 in cash or $10.20 of CapitalSource common stock.

The Company and CapitalSource have made customary representations, warranties and covenants in the Merger Agreement, including, among others, covenants regarding the conduct of their businesses and other activities between the execution of the Merger Agreement and the consummation of the Merger, and have agreed to use their reasonable best efforts to consummate the Merger. In addition, the Company has made certain additional covenants, including covenants to cause a stockholder meeting to be held to consider approval of the Merger and for the Company s Board of Directors to, subject to certain exceptions, recommend adoption by its stockholders of the Merger Agreement. Furthermore, the Company is not permitted to solicit or facilitate proposals relating to alternative business combination transactions, or, subject to certain exceptions, enter into discussions concerning alternative business combination transactions.

If, on the day the last governmental approval to complete the Merger is obtained, the ten-day average closing price of CapitalSource common stock is less than $21.98 and the trading price of CapitalSource common stock has underperformed by more than 15% the S&P 500 Financial Sector Index during the period from May 17, 2007 to that date, then the Board of Directors of the Company intends, in accordance with the terms of the Merger Agreement, to request that CapitalSource provide additional Merger consideration, either in stock or cash. The Company has informed CapitalSource that, in such circumstances, its Board of Directors would intend to make such a request. If, following such a request, the parties are unable to agree on such additional consideration, then the Board of Directors of the Company would have the right to terminate the Merger Agreement. The Merger Agreement also contains other termination rights for both the Company and CapitalSource. Upon termination of the Merger Agreement, under specified circumstances, CapitalSource may be required to pay the Company a termination fee of $40.0 million or, under other specified circumstances, the Company may be required to pay CapitalSource a termination fee of $24.0 million. The Merger Agreement also calls for a limited reimbursement of the other party s expenses under certain circumstances.

Consummation of the Merger is subject to customary conditions, including, without limitation, the accuracy of the representations and warranties of the parties (subject generally to a material adverse effect standard), regulatory approval and Company stockholder approval. On June 29, 2007, CapitalSource filed a Form H-(e)1 Application for the Acquisition of TierOne Bank by the Merger of TierOne Corporation into CapitalSource TRS Inc. with the Office of Thrift Supervision (OTS). CapitalSource has responded to OTS inquiries requesting additional information related to the filed application. At the date of the filing of this Quarterly Report on Form 10-Q, the OTS had not yet deemed the application complete or approved.

On July 13, 2007 CapitalSource filed a joint preliminary proxy statement / prospectus relating to the merger on Form S-4 with the SEC. On October 26, 2007, CapitalSource filed a joint definitive proxy statement / prospectus with the SEC on Form S-4 which established October 17, 2007 as the stockholder record date and set November 29, 2007 as the date for the Company s special meeting of stockholders to vote on the Merger. Concurrent with the October 26, 2007 filing, the Company began mailing the proxy statement / prospectus and associated voting materials to Company stockholders. Subject to timely receipt of both regulatory and stockholder approval, the Merger is expected to close either in the fourth quarter of 2007 or the first quarter of 2008.

In addition to other factors affecting the Company s financial performance discussed elsewhere in this Quarterly Report on Form 10-Q, due to the proposed merger with CapitalSource, the Company has experienced restrictions in certain funding opportunities; certain one-time merger related expenses; an increased commitment of time by Company personnel working with federal regulatory agencies in connection with merger-related issues; and restrictions in the Company s ability to repurchase its common stock. These activities have and may continue to further impact the Company s financial performance and earnings per share.

Note 3 Critical Accounting Policies

Various elements of our accounting policies, by nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. Our policies with respect to the methodologies used to recognize income, determine the allowance for loan losses, evaluating investment and mortgage-backed securities for impairment, evaluating goodwill and other intangible assets, valuation of mortgage servicing rights, valuation and measurement of derivatives and commitments, valuation of real estate owned and income taxes are our most critical accounting policies. These policies are important to the presentation of our financial condition and results of operations, involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. The use of different judgments, assumptions and estimates could result in material differences in our reported financial condition and results of operations. The following discussion regarding our critical accounting policies should be read in conjunction with our 2006 Annual Report on Form 10-K.

Allowance for Loan Losses. We have identified the allowance for loan losses as a critical accounting policy where amounts are subject to material variation. This policy is significantly affected by our judgment and uncertainties and there is a likelihood that materially different amounts could be reported under different, but reasonably plausible, conditions or assumptions. The allowance for loan losses is considered a critical accounting estimate because there is a large degree of judgment in:

- Assigning individual loans to specific risk levels (pass, special mention, substandard, doubtful and loss);
- Valuing the underlying collateral securing the loans;
- Determining the appropriate reserve factor to be applied to specific risk levels for special mention loans and those adversely classified (substandard, doubtful and loss); and
- Determining reserve factors to be applied to pass loans based upon loan type.

We establish provisions for loan losses, which are charges to our operating results, in order to maintain a level of total allowance for loan losses that, in management s belief, covers all known and inherent losses that are both probable and reasonably estimable at each reporting date. Management reviews the loan portfolio no less frequently than quarterly in order to identify those inherent losses and to assess the overall collection probability of the loan portfolio. Management s review includes a quantitative analysis by loan category, using historical loss experience, classifying loans pursuant to a grading system and consideration of a series of qualitative loss factors. The evaluation process includes, among other things:

- Assigning individual loans to specific risk levels (pass, special mention, substandard, doubtful and loss);
- Trends and levels of delinquent, nonperforming or impaired loans;
- Trends and levels of charge-offs and recoveries;

- Underwriting terms or guarantees for loans;
- Impact of changes in underwriting standards, risk tolerances or other changes in lending practices;
- Changes in the value of collateral securing loans;
- Total loans outstanding and the volume of loan originations;
- Type, size, terms and geographic concentration of loans held;
- Changes in qualifications or experience of the lending staff;
- Changes in local or national economic or industry conditions;
- Number of loans requiring heightened management oversight;
- Changes in credit concentration; and
- Changes in regulatory requirements.

This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or as future events occur.

The allowance for loan losses has two elements. The first element is an allocated allowance established for specific loans identified by the credit review function that are evaluated individually for impairment and are considered to be impaired. A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Impairment is measured by:

- The fair value of the collateral if the loan is collateral dependent;
- The present value of expected future cash flows; or
- The loan s observable market price.

The second element is an estimated allowance established for losses which are probable and reasonable to estimate on each category of outstanding loans. While management uses available information to recognize probable losses on loans inherent in the portfolio, future additions to the allowance may be necessary based on changes in economic conditions and other factors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on their judgment of information available to them at the time of their examination.

Mortgage Servicing Rights. On January 1, 2007 we adopted Statement of Financial Accounting Standard (SFAS) No. 156, *Accounting for Servicing of Financial Assets an Amendment of FASB Statement No. 140* (SFAS No. 156). In accordance with SFAS No. 156, we have elected to continue to utilize the amortization method for all of our mortgage servicing right assets, thus, carrying our mortgage servicing rights at the lower of cost or market (fair value). Under the amortization method, we amortize mortgage servicing rights in proportion to and over the period of net servicing income. Income generated as a result of new servicing assets is reported as net gain on sale of loans held for sale in the Consolidated Statements of Income. Loan servicing fees, net of amortization of mortgage servicing rights, is recorded in fees and service charges in the Consolidated Statements of Income.

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We capitalize the estimated value of mortgage servicing rights upon the sale of loans. The estimated value takes into consideration contractually known amounts, such as loan balance, term and interest rate. These estimates are impacted by loan prepayment speeds, servicing costs and discount rates used to compute a present value of the cash flow stream. We evaluate the fair value of mortgage servicing rights on a quarterly basis using current prepayment speed, cash flow and discount rate estimates. Changes in these estimates impact fair value and could require us to record a valuation allowance or recovery. The fair value of mortgage servicing rights is highly sensitive to changes in assumptions. Changes in prepayment speed assumptions have the most significant impact on the fair value of mortgage servicing rights. Generally, as interest rates decline, prepayments accelerate with increased refinance activity, which results in a decrease in the fair value of mortgage servicing rights. As interest rates rise, prepayments generally slow, which results in an increase in the fair value of mortgage servicing rights. All assumptions are reviewed for reasonableness on a quarterly basis and adjusted as necessary to reflect current and anticipated market conditions. Thus, any measurement of fair value is limited by the conditions existing and the assumptions utilized as of a particular point in time, and those assumptions may not be appropriate if applied at a different point in time. We currently do not utilize direct financial hedges to mitigate the effect of changes in the fair value of our mortgage servicing rights.

Income Taxes. We estimate income taxes payable based on the amount we expect to owe various tax authorities. Accrued income taxes represent the net estimated amount due to, or to be received from, taxing authorities. In estimating accrued income taxes, we assess the relative merits and risks of the appropriate tax treatment of transactions, taking into account the applicable statutory, judicial and regulatory guidance in the context of our tax position. Although we utilize current information to record income taxes, underlying assumptions may change over time as a result of unanticipated events or circumstances.

We utilize estimates of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future pre-tax income should prove nonexistent or less than the amount of temporary differences giving rise to the net deferred tax assets within the tax years to which they may be applied, the assets will not be realized and our net income will be adversely affected.

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Note 4 Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised. Diluted earnings per share is computed after giving consideration to the weighted average dilutive effect of our 2003 Stock Option Plan shares and 2003 Management Recognition and Retention Plan shares. The following table is a reconciliation of basic and diluted EPS:

	For the Three Months Ended September 30,	
	2007	**2006**

(In thousands, except per share data)	For the Three Months Ended September 30,			
	Basic EPS	Diluted EPS	Basic EPS	Diluted EPS
Net income (loss)	$ (5,880)	$ (5,880)	$ 11,517	$ 11,517
Total weighted average basic common shares outstanding	16,758	16,758	16,557	16,557
Effect of dilutive securities:				
2003 Stock Option Plan		435		591
2003 Management Recognition and Retention Plan		18		80
Total weighted average basic and diluted common shares outstanding	16,758	17,211	16,557	17,228
Net income (loss) per common share	$ (0.35)	$ (0.34)	$ 0.70	$ 0.67

(In thousands, except per share data)	For the Nine Months Ended September 30,			
	2007		2006	
	Basic EPS	Diluted EPS	Basic EPS	Diluted EPS
Net income	$ 5,957	$ 5,957	$ 30,426	$ 30,426
Total weighted average basic common shares outstanding	16,679	16,679	16,470	16,470
Effect of dilutive securities:				
2003 Stock Option Plan		468		578
2003 Management Recognition and Retention Plan		31		82
Total weighted average basic and diluted common shares outstanding	16,679	17,178	16,470	17,130
Net earnings per common share	$ 0.36	$ 0.35	$ 1.85	$ 1.78

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Note 5 Stock-Based Benefit Plans

General. We account for our stock-based benefit plans using SFAS No. 123(R), *Share-Based Payment* (SFAS No. 123(R)). SFAS No. 123(R) requires that compensation expense related to stock-based payment transactions be recognized in the financial statements and that expense be measured based on the fair value of the equity or liability instrument issued. SFAS No. 123(R) also requires that forfeitures be estimated over the vesting period of the instrument.

Stock-Based Employee Compensation Expense. Amounts recognized in the financial statements with respect to our Employee Stock Ownership Plan (ESOP) and stock-based employee compensation plans are presented in the following table:

	Three Months Ended September 30,	Nine Months Ended September 30,

(Dollars in thousands)	2007	2006	2007	2006
Stock-based employee compensation expense:				
Employee Stock Ownership Plan expense	$ 885	$ 1,232	$ 2,940	$ 3,611
Management Recognition and Retention Plan expense	726	726	2,178	2,178
2003 Stock Option Plan expense	420	420	1,261	1,261

Amount of stock-based compensation expense,